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Upgrading, Downgrading, Linking, Innovating: Microfinance Development Strategies - A Systems Perspective

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Microfinance Development Strategies
– A Systems Perspective –

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Abstract[*]

In the transition process from financial repression to a prudentially deregulated financial system, an increasing number of developing countries are becoming concerned about access of the rural and urban masses to microfinance. Only viable institutions with sound practices, which mobilize their own resources and cover their costs from the margin, can respond to the increasing demand for microsavings, microcredit and microinsurance services on a sustainable basis. Three major approaches contribute to the development of a system of microfinance: reform of the policy environment; institutional transformation; and instrumental innovation. In this framework there is a wide variety of institutions that have to undergo major adjustments to play their role effectively as financial intermediaries for the microeconomy: commercial and development banks; formal local banks and semiformal financial institutions under private, cooperative, community or local government ownership; credit NGOs; and informal financial institutions. Contingent upon the policy environment, the institutional infrastructure, and the degree of market integration, there are four major strategies of institutional transformation: institutional adaptation, or *downgrading*, of formal financial institutions; institutional enhancement, or *upgrading*, of nonformal financial institutions; *linking* formal and nonformal financial institutions; and, in the absence of a sufficient number of adaptable formal and nonformal institutions, infrastructural *innovation*: establishing new microfinance institutions. In each case, sound financial practices appropriate to the institution and its market are essential. There is no single *best* approach that can be simply replicated without regard to the unique situation of a country or region.

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1. The Core Problem of Financial Systems Development

In recent years a growing number of developing countries have embarked on reforming and deregulating their financial system. They have transformed their financial institutions into effective intermediaries and extended financial services to a wide array of its population. In the process a new world of finance has emerged which is demand-led and savings-driven, conforming to sound criteria of effective financial intermediation. By gradually increasing the outreach of their banking system some developing countries, among them Indonesia as an example (Binhadi 1995), have substantially alleviated poverty.

Yet in many other developing countries financial systems have not performed well, the institutional infrastructure is inadequate, institutions are not viable and financial services are not sustainable. Theirs is a world of finance which is supply-led and credit-driven, adhering to principles of social banking. The economy in these developing countries has usually remained depressed. Even where growth-oriented policies were of some success, vast segments of the population were excluded from access to formal finance.

Many governments, donors and experts have chosen to ignore new insights into the crucial importance of financial systems development (McKinnon 1973), savings mobilization (UN 1984; USAID 1991), sound credit markets (Adams, González-Vega & Von Pischke 1990; Adams, Graham & Von Pischke 1984; Von Pischke 1991) and financial deregulation (McKinnon 1991). They have continued to provide subsidized targeted credit to the microeconomy through development finance institutions (DFIs). The combined emphasis on (i) targeting, (ii) subsidization, (iii) agriculture, (iv) credit only, and (v) development banking has failed to contribute to the viability of financial institutions and the sustainability of financial systems. Despite numerous government credit programs and credit guarantee schemes (mostly a cure of symptoms rather than the disease), the financial requirements of the ever-growing market of microentrepreneurs and small farmers, women and the urban and rural poor were not adequately met.

The result was that the poor had no access to finance, institutions lost their money and governments ended up in external debts not matched by productivity increases. This in turn has restricted the absorptive capacity of both the institutions and their customers for external credit while at the same time fueling the spiral of productivity losses, defaulting and hightened government requests for additional funds to fill the gap. In the end the poor in many developing countries have remained poor, financial institutions are sick and governments are bankrupt though there are notable exceptions with important lessons for the future.

Recognizing the ill consequences of financial repression, developing countries are now embarking in increasing numbers and at varying degrees of determination on prudential deregulation. In the process, they are facing a dual core problem:

- on the one hand the lack of viability and sustainability of national financial institutions and services accessible to all segments of the population including those in the microeconomy;
- on the other hand the absence, or inadequate number, of local financial institutions (which may be member-owned, community-owned or privately owned), which are so prominent in

the financial systems of many industrial countries.

This core problem is closely related to the issue of

- supply-led finance of national financial institutions, with their exorbitant transaction costs and loan losses; vs.
- demand-led finance of local financial institutions and national institutions with a local delivery network,

related in turn to an inappropriate regulatory environment, an inadequate financial infrastructure, ineffective institutional strategies, and unsound banking practices. The financial system thus failed in its three major functions: financial resource mobilization, financial intermediation and allocation of scarce resources to the investments with the highest marginal rates of return. As a result, potential savings went uncollected; institutional intermediation between savers and borrowers was inadequate; and resources that only the market can efficiently allocate were misallocated by government bureaucracies and government-controlled development banks, frequently with donor support and expert advice.

While inadequacies of the financial system have affected all economic sectors and segments of the population, their impact has been most acutely felt by the rural and urban masses in the informal sector and those below the poverty line. To guide their future operations governments and donors need a **microfinance policy,** with a microsavings, a microcredit and perhaps a microinsurance component, centering on local financial institutions or services under conditions of prudential deregulation and supervision. Such a policy must depart from the experience that only the balanced growth of the savings, investment and repayment capacities of the microsector will lead to a steady increase in its absorptive capacity for external credit; and that only sustainable financial services provided by viable financial institutions with adequate capacities within a market economy and a favorable policy environment will contribute to that balanced growth. These are concerns which in recent years, and particularly in the context of the Microcredit Summit in February 1997 in Washington DC, have led to an avalanche of new microfinance literature (Almeyda 1996; Berenbach & Churchill 1997; Bouman & Hospes 1994; Garson 1996; Getubig et al. 1997; Gentil & Hugon 1996; Germidis et al. 1991; Ghate 1992; Hoff et al. 1993; Hulme & Mosley 1996; Johnson & Rogaly 1997; Krahnen & Schmidt 1994; Kropp & Clar de Jesus 1996; Otero & Rhyne 1994; Quiñones 1997; Remenyi 1991; Rock & Otero 1997; Schneider 1997; Seibel 1996, 1997a-c; Von Pischke 1991; Wbster & Fidler 1996). Through the DEVFINANCE@LISTS.ACS.OHIO-STATE.EDU network of the Rural Finance Group in the Department of Agricultural Economics at The Ohio State University, it has also led to hightened debates on the internet as a new medium of communication.

2. The Conventional Policy Framework: a Systems Perspective

Targeted preferential credit has been one of the major instruments of regulated finance in developing countries. Overregulation has led to financial repression at several systems levels:

(i) The government as banker, entrepreneur, policymaker, planning and executing agency has taken control over the total financial, economic and political system. This has led to a breakdown in accountability.

(ii) On the policy framework level, the government has repressed the real sector through price controls and quotas and the financial sector through monetary practices governed by political concerns rather than budgetary restraint and market rules. Controled exchange rates and agricultural prices undermined market mechanisms. Fixed interest rates prevented financial intermediation. Fiscal policies were neglected. External debts replaced domestic resources.

(iii) The legal framework has suppressed financial deepening by preemption of decisions by government bureaucracies, legal barriers against new banks and branches, and restrictions of savings mobilization and financial intermediation through institutional specialization and narrow collateral requirements.

(iv) A supervisory infrastructure was deemed unnecessary in a tightly regulated environment.

(v) Governments repressed the growth of the institutional infrastructure by submitting institutions to objectives defined through centralized planning processes and by preventing the emergence of formal local financial institutions, which were at best relegated to the semiformal and informal financial sectors.

(vi) Credit products were differentiated by target groups, areas and production purposes defined by the state. Savings products were mostly undifferentiated.

(vii) Banks were required to follow administrative procedures set by Government, confining services to a minimum and shifting the bulk of transaction costs to borrowers.

(viii) Contract terms and conditions were determined by administrative expediency.

(ix) Credit-driven and supply-leading finance has focused on target beneficiaries rather than customer demands.

(x) Strategies centered on credit channeling rather than resource mobilization and institutional viability, with financial repression the overall result. (Seibel 1994a, 1996)

3. Microfinance for the Microeconomy: Financial Systems Development Strategies

Microfinance, comprising microsavings, microcredit and microinsurance, is geared to the vast and expanding market of small farmers, tenants, small and microentrepreneurs, women and the urban and rural poor. This is a highly differentiated and segmented market, with segmentation serving the function of adaptation of terms and conditions to unique conditions on unintegrated markets (Garson 1996). It reaches from the very poor to small enterprises which give employment to the poor. In some countries this market comprises as much as 60-80 % of the population. There is a wide range of demands for financial services, comprising access to savings deposit facilities, credit, capital markets and insurance services. Microsavings, *the forgotten half of rural finance* (Vogel 1984), is of fundamental importance for local and domestic resource mobilization: (i) for the microentrepreneur in terms of his self-financing capacity; (ii) for the institution in terms of financial self-reliance. Savings are health food for both microentrepreneurs and banks. More sick enterprises and financial institutions can be cured by savings promotion than by any other remedy. Enhancing the savings capacity of financial institutions in developing countries and, indirectly, in microenterprises is perhaps one of the greatest challenges • to be promoted through the diffusion and exchange of experience about successful savings mobilization strategies and products in various developing countries.

Only financial institutions with local delivery systems can effectively provide microfinancial services to the broad masses of the population. Microfinance may be promoted through **five strategic approaches:**

> **(i) transformation of the total financial system** comprising monetary policy reform, transformation of the financial infrastructure, and instrumental innovation in coordination with fiscal and other measures geared to macroeconomic stability, reforms of the real sector and, if necessary, political and administrative reforms geared to accountability;
>
> **(ii) reform of the policy environment** comprising the policy framework proper • with a particular emphasis on interest rate policy • , the legal and the supervisory framework;
>
> **(iii) institutional transformation** geared to the development of the financial infrastructure with particular emphasis on local financial services and institutions;
>
> **(iv) instrumental innovation** geared to sound banking and sound or *best practices*[1] through

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[1]**Best practices or sound practices?** Originally introduced by the World Bank, the term *best practices* has gained wide recognition. It is an **inappropriate term,** as we learned from the organizational sciences during the 1960s that in complex organizations there are only *satisficing,* no *optimal* (or *best*) solutions. It is also a **dangerous term** in that it may lead to a search for universal solutions and to careless replication without regard to given circumstances.

Take *formalization of MFIs* (ie., the transformation of nonformal into formal MFIs that fall under the banking law) as an example: in all likelihood an effective strategy in a prudentially deregulated environment where MFIs are free to charge intererest rates that cover their costs; but probably not so under conditions of financial repression when formal institutions are barred by appropriate financial products, procedures and services, terms and conditions of financial contracts and adequate risk management; and

(v) poverty lending, comprising direct and indirect approaches.

Policy reform, institutional transformation and instrumental innovation cannot all be initiated at the same time; in many developing countries they may be contingent upon prior political reform. Prudential reform and adjustment is a gradual process which does not proceed along a predetermined path. Carried out by reformers whose experience evolves during that very process, it requires careful adaptation to an extremely complex set of internal and external factors. The development of local and microfinance must be accorded high priority in total system reform.

Policy reform, with an emphasis on prudential deregulation, is the most direct approach to financial and economic transformation, but may not be immediately feasible for political or other reasons. There also is a better chance of success for policy reform if its path has been prepared by successful institutional and instrumental experimentation. At the international level reforms of the policy environment are most appropriately promoted by the IMF and the World Bank, with regional development banks in a supportive role. Local and microfinance will best evolve in a deregulated environment but requires deeper measures than mere policy changes.

Institutional transformation focusses on the institutional environment as its entrypoint, encompassing two system levels: structurally the institutional infrastructure and functionally appropriate strategies for its development.

Instrumental innovation, which encompasses sound banking practices in terms of financial products, transaction cost management and interest rate margins, procedures and services, risk management and terms of contracts may be effectively used as a separate strategy and can greatly improve the institutional viability and effectiveness of formal and nonformal financial

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interest rate ceilings from covering the costs of microloans. As a result, microentrepreneurs will either have no access to credit; or they bear the brunt of a substantial transfer of transaction costs from lender to borrower.

Or another example: *Saving* is a good thing for microentrepreneurs, MFIs and the monetization of the local economy and should therefore be promoted. Is it therefore a *best practice,* to be disseminated through training and consultancy advise around the world? Well, it depends: under conditions of a running inflation, microentrepreneurs should be advised **not** to put their money in the bank.

In this sense, none of the strategies and practices described or recommended in this paper are *optimal* or *best*, they are at best *effective* or *satisfactory* under conditions to be specified. Every replication requires a careful examination of the circumstances under which it is to be applied. When the replication concerns a complex strategy or approach (such as Grameen banking [cf. Todd 1996], linkage banking, or village banking), **thorough adaptation** is most likely required. The term *sound practices* would therefore be more appropriate.

institutions.

Direct poverty lending is usually contingent upon the supply of government or donor funds and therefore, on principle, unsustainable. This also applies to a growing number of revolving and credit guarantee funds supplied by donors to governmental and non-governmental agencies and projects. **Indirect poverty lending,** through appropriate institutions and products, may be demand-led and savings-driven. The decision as to whether or not an institution limits its operations to a particular target group, such as the very poor, the poor or the nonpoor, should be left to the institution and not be imposed by a donor. Member-based institutions owned and managed by microentrepreneurs, women or the poor know best what is in their own interest; donors and government agencies should not interfere with that decision. (Cf. Malhotra 1992)

4. The Institutional Infrastructure of Microfinance

There is a wide range of financial institutions, each with its own comparative advantages for microfinance services, including,

- ■ formal financial institutions which comprise
    - ■ institutions dealing actually or potentially with microentrepreneurs and small farmers as customers,
    - ■ institutions owned by microentrepreneurs and small farmers;
- ■ semiformal financial institutions which comprise,
    - ■ *secondary banks* not supervised by the central bank
    - ■ near-bank institutions lacking some criteria, e.g. equity capital, to fully qualify for bank status
    - ■ financial institutions and credit projects run by government agencies but not falling under the banking act
    - ■ projects of government agencies supported by bilateral donors with a credit window, e.g. in the form of a *revolving fund*
    - ■ NGOs acting as financial intermediaries, operating credit windows or otherwise supporting savings and credit activities
    - ■ savings and credit cooperatives not formally recognized as financial institutions
- ■ informal financial institutions which may be,
    - ■ individually based and specialized such as moneylenders and deposit collectors
    - ■ individually based and nonspecialized such as traders
    - ■ group-based and specialized such as rotating savings associations (*ROSCAs, tontines*) and nonrotating accumulating savings and credit associations (*ASCRAS* - Bouman 1995)
    - ■ group-based and nonspecialized such as voluntary associations or business associations with savings and credit activities as secondary functions.

(Adams and Fitchett 1992; Bouman 1979, 1989; Germidis et al. 1991; Ghate 1992; Seibel & Damachi 1982)

Together semiformal and informal financial institutions comprise the nonformal financial sector. Within that sector, savings and credit associations which are group-based informal financial intermediaries appear to have a large development potential that some donors have in recent years started to recognize.

Nonformal (semi- and informal) financial institutions are in most cases local financial institutions. Two types of institutions are of particular importance, cutting across dividing lines between the formal, semiformal and informal financial sectors:

- institutions dealing with microentrepreneurs and small farmers as customers (*Banking with the Poor*)
- institutions owned by microentrepreneurs and small farmers (*Banking by the Poor*).

Institutions dealing with microentrepreneurs as customers may be government-owned or privately owned. Furthermore, they may be national, regional, provincial or local institutions. Such institutions may either deal solely with microfinance, or microfinance may be but a part of its operations. There is evidence that any of them may effectively mobilize its own resources and provide financial services along sound banking principles with perfect or near-perfect loan recovery and a profit margin that permits self-sustained growth. Bank Rakyat Indonesia in Indonesia may serve as an example of a large government-owned commercial bank in a deregulated environment that mobilizes its own funds in rural areas and successfully lends to vast numbers of microentrepreneurs and small farmers at market rates (Patten & Rosengard 1991; Schmit 1991; Seibel 1992e). Private sector examples are Bank Dagang Bali in Indonesia and Northern Mindanao Development Bank in the Philippines.

Under conditions of repressive regulation viable and sustainable financial services may be offered by semiformal and informal financial institutions which are exempt from the impositions of the regulatory framework. Examples of viable semiformal institutions initiated by local government is BKK on Java (Malhotra 1992; Patten & Rosengard 1991), LPN on Sumatra and several others most of which started around 1970 in Indonesia (Seibel 1989). An example of local financial institutions at the borderline of the formal and semiformal sectors are the new community banks in Nigeria, which are under their own second-tier regulatory authority, the National Board of Community Banks (Seibel 1994b). Technical assistance can greatly contribute to the establishment, expansion and enhancement of such institutions.

There are three major types of local institutions:

- member-owned (cooperative) institutions;
- community-owned institutions; and
- privately owned institutions.

These are mostly small local institutions, which are flexible and adaptive. Because of their institutional size, their sole business is microfinance. They may be formal, semiformal or informal, or combine two levels, as in the case of a village bank with a surrounding network of informal savings and credit associations as retailers. They may have great evolutionary potential: from informal to semiformal, from semiformal to formal, and from unit banking to branchingout.

Member-owned institutions of the cooperative type can be formed by any type and number of people within or accross neighboring communities, including microentrepreneurs, small farmers, women and the poor. Membership is normally contingent upon an equity capital contribution but may also include other criteria (e.g. gender as in the case of a women's bank, occupation as in the case of a market or traders' bank) and is a prerequisite for access to the institution's services. In some cases such institutions are also open to non-members but at different terms. Depending on the legal framework provided by the wider financial system, formal and semiformal member-based institutions may be cooperatively owned (cooperative banks) or individually (as as in shareholding banks). Member-owned institutions rely fully or largely on their own resources, i.e. on equity and savings. Among the financially self-reliant institutions owned by their members are vast numbers of group-based informal financial institutions. Among them are the ubiquitous rotating and nonrotating savings and credit associations. Whether nonformal institutions can evolve into banks depends on the legal framework, which is of course subject to change.

Community-owned financial institutions may be people- or local government-based. They are *people-based* if the members of the community are either directly (through individual or household membership) or corporately owners of the institution. There must be a provision in the rules and regulations or bye-laws that the community members or its recognized representatives have a say in the running of their affairs. This should also be reflected in the perceptions of the people, who should consider the institutions as *theirs.* In some developing countries community banks are *government-based,* be they government-owned or government-imposed and perceived as government institutions. In fact the dividing line between institutions owned by local government or by the people of the community is not always sharply drawn and may be as much a legal as a social issue. Similarly, while there are cases where the distinction between ownership by members or the community as a corporate body is legally or culturally clear and unequivocal, there are also many other cases where it is blurred. A useful quantitative indicator may be the extent to which community banks depend on government resources vs. savings and retained earnings as a source of funds.

Privately owned financial institutions are owned by one or several individuals, who are frequently, but not always, local people. Examples are the rural banks in the Philippines and Indonesia.

Community Banks in Nigeria are an example of a crossbreed between all three types, combining a variable mix of member, community and private ownership. By December 1993 there were 879 Community Banks co-owned by Community Development Associations, informal self-help groups and individuals (Seibel 1994b).

5. Institutional Adjustment Strategies

The basic principle of institutional adjustment must be appropriateness, with institutional viability and sustainability as lead values. Depending on the situation in a country, there may be one or several effective strategies. There are **four major prerequisites,** each related to a particular adjustment strategy:

> (i) Effective formal local financial institutions exist with a potential for adaptation to the demands of the microeconomy
>
> (ii) Effective nonformal (semiformal and/or informal) local financial institutions exist with a potential for adjustment
>
> (iii) Both formal and nonformal local financial institutions exist with a potential for adjustment and business cooperation
>
> (iv) There is a lack or shortage of effective or adaptable formal and nonformal financial institutions.

Depending on these conditions **four major institutional adjustment strategies** have emerged offering strategic entrypoints for the development of microfinance:

> (i) Institutional adaptation (or *downgrading*) of banks to the local environment
>
> (ii) Institutional enhancement (or *upgrading*) of nonformal (informal or semiformal) financial institutions
>
> (iii) Linking formal and nonformal financial institutions
> (*linkage banking*)
>
> (iv) Creating new local institutions (*infrastructural innovation*).

None of these strategies is universally applicable, nor does any single one offer optimal solutions. Their appropriateness depends on local circumstances and conditions, which need to be carefully assessed. The interrelations between strategies and conditions, together with some examples, are summarized in *Table 1.*

Table 1: **Appropriate institutional adjustment strategies**

Strategy	*Conditions*	*Examples*
Adapting formal financial institutions to the rural/informal sector environment *(downgrading)*	Effective formal institutions exist	ADBN, Nepal BAAC, Thailand BRI, Indonesia NMDB, Philippines
Enhancing nonformal financial institutions (*upgrading*)	Effective nonformal institutions exist	
Enhancing informal financial institutions	Effective informal institutions exist	Bank MBM Indon. Numerous NGOs
Enhancing semiformal financial institutions	Effective semiformal institutions exist	Coop. or NGO banks
Linking formal and nonformal financial institutions (*linkage banking*)	Both effective formal and nonformal institutions exist	Linkage banking projects in APRACA member countries
Creating new institutions (*infrastructural innovation*)	Absence or shortage of effective formal or informal institutions	Grameen Bank VBA in Vietnam APB in Laos CBs in Nigeria

Notes:

ADBN	Agricultural Development Bank of Nepal (a government-owned agricultural development bank)
APB	Agricultural Promotion Bank, Laos (a government-owned national-level agricultural develoment bank)
BAAC	Bank for Agriculture and Agricultural Cooperatives, Thailand (a government-owned agricultural bank)
Bank MBM	Bank Maha Bogha Marga, Denpasar (the first NGO bank in Indonesia)
BDB	Bank Dagang Bali (a privately owned commercial bank in Indonesia)
BRI	Bank Rakyat Indonesia (the largest rural-agricultural Bank in Indonesia, government-owned, operating as a commercial bank)
CBs	Community Banks, under the National Board of Community Banks as a second-tier regulatory authority in Nigeria
Grameen	Grameen Bank, Bangladesh (a group-based bank, mixed ownership)
NMDB	Northern Mindanao Development Bank (a private thrift bank, Philippines)
VBA	Vietnam Bank for Agriculture (a government-owned agricultural bank)

5.1. Downgrading:[2]
Formal Finance and the Institutional Adaptation Strategy

In virtually every developing country there are commercial and development banks with a potential for adjustment to the banking requirements of microentrepreneurs and the poor. To tap this vast potential is a major challenge.

The prime **prerequisite** and at the same time crucial policy incentive for institutional adjustment is an interest rate regime which allows for market oriented interest rates. Banks must be permitted to offer attractive and differentiated interest rates to savers and to charge interest rates on loans which cover their fixed and variable costs, and include an adequate profit margin. If banks are to serve customers which differ widely in terms of service costs and risks, the only effective inducement for them is an adequate margin, lest they exclude the small farmers, micro-entrepreneurs and people in remote areas. In the absence of this prime prerequisite banks may pursue one of the following three courses: they may request an exemption from the central bank; they may externalize part of their costs by working through intermediaries with separate funding (e.g. NGOs); or they mey set up a non-bank organization with a separate legal personality (e.g., a limited liability company) which does not fall under the interest rate regulations of the banking law. However, these approaches should only be transitory; they are no long-term substitute for interest rate deregulation.

Institutional adaptation of banks to the microfinance market concerns: (i) their governance and incentive structure; (ii) their corporate culture; (iii) their internal business and product policy; (iv) their financial service structure; (v) bank procedures; (vi) terms and conditions; (vii) risk management; and (viii) the manpower and training system. For virtually all of these dimensions, *Bank Rakyat Indonesia (BRI)* may serve as a model case.

(i) Adapting a bank's governance and incentive structure may follow any of the following avenues:

- ■ transformation of a subsidy-dependent government bank, with management and staff selected and rewarded according to administrative criteria, into a profit-oriented self-reliant institution, with management and staff selected according to performance criteria;
- ■ transformation of branches into profit centers with a performance-related staff incentive scheme, as in the case of the so-called village units (*unit desa*) of Bank Rakyat Indonesia;
- ■ separation of commercial banking with big clients and social banking with small

[2] I adopted the term *downgrading* from the technology debate in the 1970s. *Downgrading* is the adaptation of a sophisticated technology to an environment requiring a simpler technology, e.g. the substitution of handtools for powertools in an area without access to electricity. If production is shifted at the same time to products for which powertools are not suitable (e.g., artistic woodcarving), there are gains from *downgrading* in terms of effectiveness as well as efficiency. In this sense, *downgrading* may acquire a positive connotation.

clients in different sections and gradual transformation of social into commercial microfinance, as in the case of the Agricultural Development Bank of Nepal (ADBN) and the Vietnam Bank for Agriculture;

- ■ privatization of a government-owned bank, or its commercial section as a first step
- ■ transformation of branches or microfinance project offices into cooperatively owned local financial institutions, as in the case of ADBN in Nepal, which is currently transforming the financial operations of the Small Farmer Development Program subproject offices into Small Farmer Cooperatives Ltd. (SFCL)

There is widespread, though not universal, consensus that government should give up its ownership of commercial and development banks und put it into more accountable hands. However, what remains controversial is whether these hands should be private, cooperative under direct member control, cooperative under the control of management, or either one depending on given circumstances or on the objectives or mission of an institution (e.g., maximization of profits vs. optimization of client services). An additional variant for government, cooperative and private banks is the separation of ownership and management, with management placed in the hands of a management firm which bears all costs and shares in the profit (as practiced by some banks in Belgium and by some credit NGOs in Guatemala initiated by ACT, a Belgian NGO). The strategy of some agricultural development banks (like the Vietnam Bank for Agriculture) to divest themselves of their microfinance operations by setting up a heavily subsidized *Bank for the Poor* for the disbursement of preferential targeted credit to the poor and the very poor repeates the mistakes of the past; it contravenes the principles of sound banking and sustainable poverty alleviation; and lacks the dynamics of adequately responding to the growing demands of vast numbers of the poor for a full range of financial services.

(ii) Adapting the corporate culture at the local level requires an adjustment of the bank's material culture (such as the appearance of the bank building and its offices, types of vehicles, facilities such as air-conditioning); social culture (such as social background, dress code, language and behavior of staff as well as quality of staff-customer relations); and the bank's value orientation system (comprising values such as honesty and reliability, diligence and hard work, innovativeness, being of service to the customer, making the bank grow). This customer-oriented corporate culture must be internalized through staff training and propagated through public relations as the bank's image.

(iii) Adapting the banks' business and product policy requires a reorientation towards savings- and demand-driven sound banking. This comprises in particular an orientation of a bank towards institutional viability, market and customer-oriented banking and self-reliance through mobilization of its own funds of which **savings**, and perhaps retained earnings are the most important sources of loanable funds for MFIs. This reorientation is to be operationalized through appropriate microsavings, microcredit and microinsurance products as well as reciprocal savings-cum-credit schemes which are all designed to bring the mutual business interests of the banks and their customers into a sound balance.

(iv) Adapting the financial service structure of a bank may comprise four major avenues towards local finance:

- extending the branch and sub-branch network;
- the establishment of part-time offices in villages, markets or small industry sites;
- mobile services through cars, motorcycles or bicycles;
- full-time or part-time agents providing doorstep or other decentralized services.

(v) Adapting procedures requires a simplification of forms and procedures, convenient facilities and banking hours, customer-oriented services of high quality as well as reliability and speed of services, creditworthiness examination and collateral requirements adjusted to the needs of small customers.

(vi) Adapting terms and conditions of contracts to the requirements of microentrepreneurs and informal sector households comprises a differentiation of interest rates and other terms according to area or customer groups with different risk and cost structures; a differentiation of terms according to the length and quality of the business relationship, including a difference in terms between initial and subsequent repeat loans; an emphasis on small sizes of savings, loans and installments; variable but short maturities; frequent instalments; no or short grace-periods.

(vii) Adapting risk management comprises a comprehensive strategy for arrears prevention, including appropriate loan and instalment periods; effective collection services; an adequate mixture of formal and nonformal collateral and collateral substitutes; reliance on a borrower's track record based on savings and previous loan repayment behavior; personal guarantees and various forms of joint liability in cooperation with voluntary associations including joint liability groups, the latter successfully practiced by BAAC in Thailand and VBA in Vietnam on a broad scale; and incentives for timely repayment, e.g. in the form of a substantial interest rate rebate as practiced by BRI in Indonesia.

(viii) Adapting the manpower and training system requires a selection of staff with particular language and social skills, which may be more important than formal certification, and inclusion of customer-oriented social behavior, microloan appraisal, arrears prevention etc. in the training curriculum. This may also include exposure training programs for bank executives and management in other banks, perhaps in neighboring countries, which can serve as examples of successful adaptation.

Formal financial institutions serve but a fraction of the population, typically within the upper quartiles of the social hierarchy. When **adapting to requirements of the microfinance market**, they may gradually expand into the lower quartiles. Within the foreseeable future they will normally not be able to fully serve that market. To reach the whole market, the institutional adaptation strategy for formal financial institutions (*downgrading*) must be complemented by an *upgrading* strategy for nonformal financial institutions. The former is a top down approach, the latter bottom up.

5.2. Upgrading: Nonformal Finance and the Institutional Enhancement Strategy

Nonformal finance, which mostly rests on local institutions, comprises those financial sectors which are directly accessible to virtually the whole population. There are two principal approaches: (i) organizational development within the framework of their given legal form (which is legal according to common law in a given area but extralegal in terms of national law); (ii) promoting the transition of an institution to a higher-order legal form, such as a credit cooperative or bank.

These two upgrading approaches may either be directed at primary or secondary organizations: (i) enhancing the capacity of grassroots financial institutions including self-help groups and *people's organizations;* or (ii) enhancing the capacity of self-help promoting institutions like NGDOs (non-governmental development organizations).

Self-help groups (SHGs) as member-owned and member-controlled local institutions may either be (i) financial groups, with financial intermediation as their primary purpose, such as rotating and nonrotating savings and credit assocations; or (ii) nonfinancial groups, with financial intermediation as a secondary purpose, such as vendors associations, craft guilds, family planning groups and numerous other types of voluntary associations. Their functions may include:

- providing guidance to members
- collecting savings from members
- building up an internal loan fund
- loan appraisal and creditworthiness examination
- financial consultancy services to members
- arranging for nonformal collateral or guarantees including joint liability
- granting loans to members
- size and term transformation
- collecting instalments
- applying social control mechanisms to enforce repayment
- granting emergency loans
- granting nonfinancial emergency assistance
- providing insurance services
- communication and exchange of experience
- providing linkages with banks, NGOs or donors
- supporting the loan applications of individual members to banks through recommendations

While the activities of SHGs are usually well-adapted to local conditions, they frequently lack technical skills, networking capacities and access to sources of refinance.

The possibility and appropriateness of **acquiring bank status** by SHGs depends on the legal framework and on their financial and organizational maturity. In countries with an appropriate legal framework financial SHGs may be assisted in establishing a member-owned and member-controlled bank. In countries without such a framework, SHGs may be assisted in establishing a semiformal financial institution registered as a non-bank institution until the law is changed. In cases where an SHG cannot immediately fulfil the conditions of the banking law, acquisition of a non-bank legal status, e.g. under cooperative law, association law, etc., may provide an interim solution which permits a SHG to undergo a process of upgrading until it is mature and capitalized enough for bank status. In countries with effective savings and credit cooperatives the feasibility of converting them into cooperative banks may be examined. In countries where cooperatives under the authority of a cooperative department have failed to mature into viable financial institutions (e.g., as a result of credit conduiting on behalf of the government), rehabilitation with the objective of transforming them into member-owned banks under the supervision of the central bank may provide a feasible alternative, which would in turn require massive technical assistance. SHGs may also be partial or full owners of local banks, as in the case of the Nigerian community Banks (Seibel 1994b).

Non-governmental, or private voluntary, development organizations (NGDOs, NGOs, PVOs) may either be (i) humanitarian organizations, usually relying on donor support, working for the benefit of others such as self-help groups and microentrepreneurs or small farmers; or (ii) apex and umbrella organizations of financial self-help groups, business associations and the like working for the benefit of their own members. The latter may be member-owned and member-directed; the former, as a rule, are not. Examples of the latter are regional and national federations of credit cooperatives, craft unions or market vendors associations. While their start-up phase may be donor-supported, they are to be financially self-reliant in the long run, drawing on their own resources and those of their members.

NGDOs acting directly as financial intermediaries or working through financial self-help groups may have two basic functions: (i) guidance, training and consultancy in financial and nonfinancial matters; (ii) acting as a financial intermediary between microentrepreneurs or their self-help groups and donors or banks.

The activities of **NGDOs as financial intermediaries** may include any of the following:

- financial extension services
- bookkeeping training
- financial management training
- promotion of innovative savings schemes, e.g. daily or doorstep savings collection in the informal sector, withdrawable voluntary savings as well as time deposits in self-help groups (SHGs), etc.
- internal resource mobilization through debt instruments (e.g., *titulo de credit* of Genesis Empresario, a credit NGO in Guatemala not authorized to mobilize conventional savings)
- mediating contacts with a bank or donor
- collecting and safekeeping savings
- depositing savings of microentrepreneurs of SHGs in a bank
- examining the creditworthiness of microentrepreneurs or SHGs
- negotiating bank loans for microentrepreneurs or SHGs
- onlending to microentrepreneurs or SHGs
- collecting installments from microentrepreneurs or SHGs
- bearing the credit risk

- repaying bank loans

NGDOs not acting as financial intermediaries may still carry out several of these functions, except accepting savings and entering into loan contracts. For NGDOs acting directly or indirectly as financial intermediaries it is mandatory to possess an adequate accounting system, financial management skills and financial reserves to absorb arrears and bear the risk. They should also strive for external auditing of their books. For NGDOs which strengthen financial capacities of microentrepreneurs or SHGs it is mandatory to possess adequate training and consultancy capacities. This in turn requires major institutional enhancement inputs from donors, as many NGDOs lack the required skills and capacities.

NGDOs acting as financial intermediaries operate under **precarious economic and legal conditions.** Legal constraints keep them from offering a full range of financial services, particularly the collection of savings; easy money lures many, though not all, into donor-dependency; absence of supervision keep them from having their books audited; lack of performance pressures and banking skills makes them unviable.

Llanto and Chua (1996) examined the **transaction costs of two NGOs** in the Philippines, which they found exorbitant: 34.0% of loans outstanding in one and 83.5% in the other case; they compared unfavorably with private rural banks (12.1%), cooperative rural banks (7.5%), credit cooperatives (6.3%) and of course private commercial banks (8.0%) as well as specialized government banks (10.0%) with their much larger loan sizes. (McGuire & Conroy 1997:79). Do NGOs promote savings in any significant way? Almeyda (1996:117-118) found, no, unlike ROSCAs, they don't, except "NGOs that have evolved into new formal financial intermediaries". However, if cheap donor funds continue to be supplied generously, as in the case of the Grameen Bank (Yunus 1997), the mobilization of internal resources in the form of voluntary savings may be discarded as too expensive.

To put their operations on a **sound legal footing,** they may formalize their financial activities and governance structure in one of the following ways: (i) contribute first to the bankability of their target group (individuals or SHGs) and then turn their financial operations over to suitable banks while specializing on training and consultancy services; (ii) establish their own bank operating along sound banking principles (usually as a subsidiary); (iii) establish a bank jointly with the SHGs or microentrepreneurs and small farmers under their guidance. In the latter case the NGDO may either consider its engagement in banking permanent or transitory, with the intention of eventually turning ownership and management over to the SHGs or microentrepreneurs.

The upgrading of nonformal financial institutions or operations of NGDOs and SHGs into private or cooperative banks which operate along sound banking criteria may be a major field of financial or technical assistance. The operational details of SHG upgrading are presented in a modular training manual (Seibel 1992a). One of the most prominent recent examples of an NGO turned bank is BancoSol in Bolivia (Gonzalez-Vega et al. 1996). Since the institutional deregulation of 1988, there has been a variety of NGO banks in Indonesia (e.g., by Bina Swadaya, Duta Bina Bhuana, Maha Bogha Marga, Purba Danarta) which may serve as models (Seibel 1997a). With the passing of a development banking act in Nepal, Grameen-type NGOs are now being replaced by Grameen-type development banks (Seibel 1997b).

As MFIs are upgraded from nonformal to formal, **regulation and supervision** become issues of increasing importance (Rock & Otero, 1997). Given their large number and diversity, central banks or bank superintendencies (Christen 1997:47) may not be well suited for their effective supervision. MFIs may therefore be well-advised to establish networks with their own second-tier regulatory authority, with effective off- and on-site mechanisms, as in Peru and Bolivia (Berenbach & Chruchill 1997:49-55), Nigeria (Seibel 1994b) and developed countries such as Germany with its long tradition of differentiated second-tier supervision of commercial, cooperative and savings banks under a single credit law.

5.3. Linking: Formal and Nonformal Finance and the Linkage Strategy

The linkage banking strategy focusses on the establishment of business relations between formal and nonformal financial institutions, the latter encompassing endogenous and exogenous self-help groups. It first emerged from spontaneous local initiatives in Africa which found the attention of researchers, the FAO and GTZ (Seibel 1984, 1985, 1987; Seibel, Dédy, Herwegen & Kadja 1987; Seibel & Marx 1987). In 1986, the strategy gained momentum when it was adopted by the Asian and Pacific Regional and Agricultural Credit Association (APRACA) as lead agency, resulting in pilot projects in Indonesia, the Philippines, Thailand and Nepal (Acharchya et al. 1990; ADB 1990:209-211; APRACA 1996; Conroy et al. 1995; Ghate 1992:184-192; Kropp et al. 1989; Kropp & Quinones 1992; Kropp & Clar de Jesus 1996; Seibel 1989; Seibel & Parhusip 1992). The approach is now spreading to other countries in Asia including India where NABARD applies the approach on a broad national scale and, through AFRACA (1996), in Africa. Nagaranjan & Meyer (1996) have shown how rotating savings and credit associations (ROSCAs) in Gambia have been successfully linked to NGO banks. In the 1989 World Development Report linkage banking was recommended as a promising strategy of financial system development:

> *Informal financial institutions have proved able to serve the household, agricultural, and microenterprise sectors on a sustained basis. Measures that link informal institutions to the formal financial system will improve that service and ensure a competitive environment* (p. iv; cf. p. 119).

Departing from the transaction cost problem the linkage strategy focusses on self-help groups as grassroots retailers mediating between banks and the vast numbers of microentrepreneurs and small farmers to cut down on transaction costs for both banks and customers. The linkage strategy also encompasses measures of upgrading nonformal financial institutions and the institutional adaptation of banks. Several **guiding principles** have emerged:

- Working through existing formal and informal institutions
- Institutional autonomy
- Promoting savings mobilization
- Promoting credit delivery at market rates

- Linking savings and credit
- Substituting group liability and nonformal for physical collateral
- Ensuring institutional viability by covering the costs from the margin
- Sound banking practices

In the implementation the linkage strategy is designed to participatively initiate linkage processes, rather than prescribe specific models. Any specific schemes are to be the outcome of participative processes among the respective participants. There are two principal linkage dimensions: (i) **institutional linkages** between SHGs and banks, which may either be indirect through self-help promoting institutions as intermediaries; or direct; and (ii) **financial linkages** (*reciprocity*) between savings and credit, either in fixed ratios, with the amount of credit contingent upon the amount of savings, or in dynamic ratios, with the amount of credit increasing with the number of successful repayment cycles, ensuring a gradual growth of the balance between credit and borrower capacity to save, invest and repay.

After the abismal record of subsidized targeted group lending lending schemes in the past, such as BIMAS in Indonesia, linkage banking has frequently been regarded with suspicion. Is the **performance** of schemes in which existing self-help groups with internal savings and credit activities are linked to banks different from those in which the Government establishes groups as credit channels?[3] In India Puhazhendhi (1995) found that linkage banking raised **repayment rates** from 34.7% to 97.2% At the same time **bank transaction costs** fell from $3.68 per loan (held constant at $170 across models) in individual lending to a low of $2.19 in loans to SHGs as financial intermediaries; transaction costs were between these two figures when banks lent directly to individuals involving SHGs and NGOs as nonfinancial intermediaries ($2.72) and when banks lent to NGOs who in turn lent to SHGs as retailers ($2.85). The impact on **borrower transaction costs** was found to be more substantial: amounting to $9.40 per loan in individual lending without NGO and SHG involvement, $5.70 in direct bank lending to individuals with NGO and SHG involvement as nonfinancial intermediaries; $1.40 in bank lending to SHGs with NGOs involved as nonfinancial intermediaries; and $1.25 in bank lending to NGOs who in turn lend to SHGs as retailers. (McGuire & Conroy 1997) The overall conclusion is that linkage banking can be an effective *transition facilitator* (Remenyi 1997) between banks and microborrowers who may eventually graduate to direct access to banks (unless they decide to upgrade their SHG to a formal sector MFI). As a result of NABARD's facilitation of linkage banking, substantially more banks in India now lend to microentrepreneurs and small farmers; and substantially more poor people have access to bank services.

Institutional linkages between banks and SHGs may proceed in an **evolutionary sequence** of three steps: from indirect linkages to direct linkages and ultimately to direct access of microentre-

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[3] I am not arguing that government agencies are unable to channel credit through groups efficiently. With the right incentives and price signals, a reasonable performance can be attained. An example is P4K in Indonesia, an IFAD- and UNDP-supported government project, in which BRI has supplied credit to some 40,000 small farmer groups (12/1996) on the condition it would make a profit in the process, which BRI claims it did. (Seibel 1996:59-62; 1997a)

preneurs to banking services • with the proviso that SHGs might also evolve into local banks servicing their members directly. Between these stages, there may be intermediate steps, with NGOs or SHGs, respectively, in a consultative role. It is important not to ignore these transition dynamics, which were part of the model from its onset (Seibel 1985), and not to blindly replicate the approach as if linkage banking, like Grameen banking, were a panacea.

5.4. Innovating: The Infrastructural Innovation Strategy

Infrastructural innovation, i.e. the establishment of new local financial institutions, can be an appropriate approach where no suitable institutions exist or existing institutions cannot be upgraded or adjusted to local requirements. If approaches of downgrading, upgrading or linkage banking are found inadequate in coping with local demands, infrastructural innovation can also serve as a complementary or competitive strategy and contribute to institutional differentiation.

There are three basic requirements for viable and sustainable institutional innovations in microfinance on a competitive market: (i) they must be demand-driven, i.e. respond to felt needs and articulated demands for financial services; (ii) they must be savings-driven, both in the interest of institutions and their customers as savers; (iii) they must cover their costs from the margin. In addition to commercial and developing banks which may be *downgraded*, there are three types of local institutions facing the challenge of these requirements:

- community-based financial institutions which are owned and controlled by a local community
- member-based financial institutions owned and controlled by their members.
- privately owned institutions, such as rural shareholding banks and finance companies.

Mixed ownership is of course also possible, e.g. comprising owners such als members of the local community, local, provincial and national Government, and NGOs.

Community and member-based institutions[4] are normally small local institutions, but member-based institutions may also have a wider, potentially national, outreach. An example is Grameen Bank in Bangladesh, a national institution which is 80% member-owned and 20% government-owned. Starting from small and semiformal project origins, it now links informal groups as grassroots intermediaries to a complex formal bank branch network. Another example are the community banks in Nigeria, which are independent local institutions forming part of a national network under their own national regulatory institution and regional representative offices. Examples of private banks with sustainable microfinance services are the Northern Mindanao Development Bank in the Philippines, Bank Shinta Daya and Bank Dagang Bali, both in Indonesia.

[4] In Germany, community-owned savings banks *(Sparkassen)* and member-owned cooperative banks *(Raiffeisenbanken, Volksbanken)*, which evolved from informal beginnings in the early 19th century, today account for 50.9 % of all loans and 77.2 % of all savings [December 1993]: one of the biggest and most successful network of microfinance institutions in the world.

Given the proximity of community- and member-based institutions to the grassroots level and their amenability to local control, the two types of institutions face particular risks and cope with problems arising from social stratification and inequality in different ways. Community-based as well as private financial institutions tend to integrate different classes, risking unequal access to services and an internal transfer of resources from the poor to the wealthy. Depending on the volition of the members, member-based financial institutions may or may not integrate different classes, running the danger of adverse selection. Appropriate coping strategies are a reinforcement of democratic control through carefully selected boards (which may be advisory, supervisory or management boards) in the former and of professional management in the latter case. An appropriate balance between democratic control and professional management will present a permanent challenge to any cooperative banking system, considered by some a (mostly social) strength and by other a (mostly economic) weakness: at present a hotly debated issue in the German cooperative banking system.

Depending on national and local circumstances new institutions may be established in the formal, semiformal or informal financial sectors. New formal financial institutions may be set up in cooperation with the central bank or major national, regional or provincial banks, including development banks and banks with a rural mandate, as facilitators or intermediaries, seconded perhaps by well-prepared NGOs in their capacity as training and consultancy agencies. New semiformal financial institutions which include cooperatives and GO and NGO-supported financial programs, may be established through cooperative or NGO networks and apex organizations which need to be adequately qualified for that task. Group-based informal financial institutions may be set up in cooperation with NGOs and cooperatives, usually through their respective networks and apexes, which in turn have to provide adequate training and facilities to their member institutions. Under favorable conditions government institutions may also succeed in establishing financial self-help groups, as in the case of the **P4K** project of the Department of Agriculture in Indonesia; between 1990 and 1996 it has set up 47,500 small groups, provided access to bank credit (at a repayment rate of 97.5% of credit disbursed and 90.4% of credit outstanding as of 12/1996) and inspired processes of institutional self-reliance through the mobilization of savings and the formation of close to 2,000 associations (Seibel 1997a).

The sequencing of infrastructural innovation should be planned and implemented with a view towards the other three institutional strategies as complementary or successive strategies. In countries with an inappropriate policy environment and a lack of adaptable institutions intervention may start with infrastructural innovations at the informal or semiformal level; to be followed in another phase by upgrading within the nonformal framework; next by infrastructural upgrading of the most successful institutions to semiformal institutions and eventually banks; then by linkages between nonformal and formal institutions; and finally by a general transition to formal institutions. Grameen Bank in Bangladesh is one of the most impressive examples.

Decisions concerning the most effective strategy, level and approach are best left to competitive market forces rather than government or donor authority.

6. Supportive Strategies and Sound (*Best*) Practices

Strategies supportive of institutional adjustment are important at the policy and instrumental level. A friendly, deregulated policy environment with an appropriate legal framework will greatly facilitate any approach to institutional adjustment. In a less than friendly or even hostile environment, two supporting strategies may be feasible: (i) niche-seeking in the short run and (ii) policy reform in the medium or long run. Experience from pre-deregulation Indonesia shows that even within an inappropriate policy environment financial services can be viable at the grassroots level. Examples are BKK in Central Java and LPN in West-Sumatra (Malhotra 1992; Seibel 1989; Seibel 1996).

A successful institutional adjustment strategy must encompass a sound **instrumental innovation strategy,** which in turn comprises improved or new financial products, good procedures and effective contractual terms and conditions, which may be summed up as banking according to sound commercial principles. This applies to any sector, formal or nonformal. Certain, but not all, instrumental strategies, such as the ability of a bank in the formal financial sector to cover its costs from the margin, will depend on the policy environment, specifically on the existence or absence of interest rate ceilings. But in government-approved niches or in the nonformal sector virtually *any* strategy can be implemented regardless of the regulatory environment (though perhaps at a special cost for the circumvention of existing regulation).

Microsavings products and innovations to be promoted may comprise convenient deposit facilities for the accumulation and safeguarding of savings for microenterprise self-financing, consumption and emergencies; positive real returns to prevent erosion by inflation; savings products that differ in yield, maturity and incentive structure, such as voluntary savings withdrawable at any time or fixed deposits vs. self-imposed regular compulsory savings that are non-withdrawable, lottery savings or raffles; debt instruments (*titulo credito*) for the mobilization of internal resources by institutions not authorized to mobilize savings deposits; and collection services organized by institutions or customer groups, such as doorstep daily savings collection. In subsistence agriculture and marginal informal sector activities where virtually any type of credit may be inappropriate savings promotion that strengthens the self-financing capacity can be the only responsible financial strategy.

Microcredit products may be appropriately differentiated in terms of maturities, instalments, services and collateral requirements (ranging from joint liability and personal guarantees to tangible collateral and pawning), rather than in terms of loan use, which is costly to appraise and, for fungibility reasons, difficult to control. Viable and sustainable microcredit schemes require: prudent adjustment to household savings, investment and repayment capacities; small loan sizes, with ceilings growing over a cycle of repeat loans up to a level determined by the absorptive capacity of the microenterprise and household economy; dynamically growing savings-to-credit ratios; market rates of interest autonomously determined by financial institutions and differentiated according to costs and services provided; loan maturities and repayment modalities according to customer needs and differentiated, in case of wholesaling, according for each level of intermediation; short maturities, no grace periods and short instalment periods in case of initial loans; insistence on, and incentives for, timely repayment; and the development and provision of cost-effective monitoring systems.

Product reciprocity ties credit to savings, improves savings discipline and establishes a track record for otherwise unbankable customers, thus offering an inexpensive solution to the information problem.

Through **collection reciprocity** an institution may combine the collection of savings with the collection of instalments, which can be crucial to arrears prevention in the informal sector where incomes are daily or irregular, but not monthly, and are likely to escape collection without appropriate collection techniques. Recovery rates can be further improved by tied lending, interlinking credit with commodity transactions: a widespread practice in the nonformal sector that can also be successfully applied by formal institutions.

Microfinance procedures and services should be (i) set by financial institutions rather than government; (ii) customer-oriented, i.e. simple, fast and on time; (iii) market-oriented and in competition with those by other formal or nonformal institutions; and (iv) cost-covering. These principles should be applied with the objective of attaining: (i) sound financial management, (ii) convenient and safe savings collection and deposit facilities, (iii) appropriate loan appraisal and processing procedures, (iv) adequate risk management (including collateral substitutes, nonformal collateral, loan protection schemes and prudent loan disbursement), (v) effective monitoring and repayment collection and (vii) effective information gathering, all of which may include cooperation between different formal and nonformal intermediaries in fields where each is most effective.

Terms and conditions of financial contracts must be sound from both an institution's and its customers' viewpoints. To arrive at **balanced loan contracts** an exchange of experience and mutual learning may be required between the various types of nonformal and formal institutions including: (i) informal financial institutions with their wide range of contractual terms concerning interest rates, loan sizes, maturities, grace periods, loan purposes, reciprocities, collateral requirements, services, transaction cost sharing arrangements and unbounded innovations; (ii) semiformal financial institutions including projects and programs, which tend to be influenced by governmental or non-governmental donors and may combine comprehensive services with a lack of commercial orientation; (iii) formal institutions on tightly regulated markets, with a narrow and usually inflexible range of contractual terms; and (iv) formal institutions on deregulated markets with their much wider range of terms, transaction cost sharing arrangements and innovations. Ultimately savers and borrowers must be regarded as a market for financial institutions, with the institutions as intermediaries and savers and borrowers as customers rather than beneficiaries. Contractual terms and conditions on that market are to be the result of negotiation and competition rather than administrative imposition and convenience. In this regard, it is up to the microfinance institutions and their business associations to articulate their demand for changes in the policy and legal environment, in bank supervision, and in training and consultancy services to be provided on a national level • rather than leaving this to imposition from the Central Bank and the IMF and their good intentions.

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